

SURREBUTTAL TESTIMONY OF

ZACHARY J. PAYNE

ON BEHALF OF

THE SOUTH CAROLINA OFFICE OF REGULATORY STAFF

DOCKET NO. 2018-319-E

**IN RE: APPLICATION OF DUKE ENERGY CAROLINAS, LLC FOR
ADJUSTMENTS IN ELECTRIC RATE SCHEDULES AND TARIFFS AND
REQUEST FOR AN ACCOUNTING ORDER**

Q. PLEASE STATE YOUR NAME, BUSINESS ADDRESS, AND OCCUPATION.

A. My name is Zachary J. Payne. My business address is 1401 Main Street, Suite 900, Columbia, South Carolina, 29201. I am employed by the South Carolina Office of Regulatory Staff (“ORS”) in the Audit Department as a Senior Auditor.

Q. ARE YOU THE SAME ZACHARY PAYNE WHO PRESENTED DIRECT TESTIMONY IN THIS DOCKET?

A. Yes. I pre-filed direct testimony related to ORS’s findings and recommendations for certain adjustments in this proceeding on February 26, 2019.

Q. WHAT IS THE PURPOSE OF YOUR SURREBUTTAL TESTIMONY IN THIS PROCEEDING?

A. The purpose of my surrebuttal testimony is to address certain issues raised in the rebuttal testimonies of Duke Energy Carolinas, LLC (“Company” or “DEC”) witnesses Kim H. Smith, Robert B. Hevert, and Dr. Julius A. Wright. In my surrebuttal testimony, I will address the Company’s position regarding the assertion the Company is “entitled” to a return

on deferred expenses until the money spent is fully recovered. I will also clarify the Company's mischaracterizations of my direct testimony. The issues I am addressing in surrebuttal are specific to Company and ORS Adjustments 7, 13, 18, 19, 30, and 35, all of which are related to accounting deferrals.

Q. WILL ORS'S RECOMMENDED TREATMENT OF THE COMPANY'S ACCOUNTING DEFERRALS ADDRESS THE CONCERNS OF THE USING AND CONSUMING PUBLIC, ALL CLASSES OF CUSTOMERS, AND ALLOW THE COMPANY TO CONTINUE TO PROVIDE RELIABLE AND HIGH-QUALITY SERVICE?

A. Yes.

Q. PLEASE EXPLAIN WHY.

A. ORS's proposals represent a reasonable and equitable approach to the Company's recovery of deferred costs. ORS's recommendations allow the Company to include costs that were largely incurred outside of the Test Year, by including approximately \$24,000,000 in amortization expense and including approximately \$115,000,000 in unamortized deferral balances in rate base. As illustrated in the table below, the ORS's recommended accounting treatment contributes approximately \$33,000,000 to the ORS proposed revenue increase of \$82,357,000 or more than 40%. In comparison, the Company's proposals related to recovery of deferred balances included approximately \$75,000,000 in amortization expense and included approximately \$243,000,000 in unamortized deferral balances in rate base. The Company's recommended treatment contributes roughly \$94,000,000 (more than 40%) to the Company proposed revenue increase of \$230,807,000.

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Table 1.1 – Proposed Treatment of Accounting Deferrals			
	ORS Proposal	Company Proposal	Difference
Amortization Expense	\$24,000,000	\$75,000,000	(\$50,000,000)
Unamortized Deferral Balances in Rate Base	\$115,000,000	\$243,000,000	(\$128,000,000)
Resulting Revenue Requirement	\$33,000,000	\$94,000,000	(\$61,000,000)
Total Revenue Requirement	\$82,357,000	\$230,807,000	(\$148,450,000)

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3 The majority of Company's witnesses Smith, Hevert and Wright rebuttal testimony
4 addresses the issue of return on deferred costs and rate base treatment for the accounting
5 deferrals. For comparison purposes, ORS calculated the difference from the Company's
6 proposal based solely on the aspect of a return on deferred costs and rate base inclusion. If
7 ORS's recommendations incorporated the same amortization periods as the Company, and
8 did not include a change to the allowable coal ash costs, ORS's reduction to the Company's
9 revenue requirement based on the ORS recommended accounting treatment of deferred
10 balances would have been approximately \$4,000,000. The ORS recommended accounting
11 treatment for deferrals is a relatively minor reduction to the Company's operating
12 experience.

13 **Q. WHAT SOUTH CAROLINA STATUTES OR REGULATORY STANDARDS**
14 **GOVERN THE RECOVERY OF A COST OF CAPITAL RETURN ON A**
15 **DEFERRAL BALANCE?**

16 **A.** ORS did not locate any South Carolina statutes or regulatory standards that govern
17 recovery of a cost of capital return on a deferral balance. Therefore, the Public Service

Commission of South Carolina (“Commission”) has the duty to determine the most equitable treatment of the deferral balances for the customers and the Company.

Q. WHAT JUSTIFICATION DOES THE COMPANY OFFER FOR INCLUSION OF A COST OF CAPITAL RETURN ON THE RECOVERY OF THE DEFERRAL BALANCES?

A. The Company witnesses do not offer, in rebuttal testimony, a South Carolina statute or accounting standard to support the Company’s inclusion of cost recovery of the weighted average cost of capital (“WACC”) in the recovery of the deferral balances in Adjustments 7, 13, 18, 19, 30, and 35. Outside of the coal ash cost disallowance proposed by ORS witness Dan Wittliff, the main point of disagreement between the Company and ORS is the issue of whether the customers should pay the Company the WACC on the Company’s deferred costs.

The Company claims deferred costs were 100% financed by debt and equity because the deferred costs were not included in the Company’s cost of service. Therefore, the Company asserts it should be allowed to recover financing costs by calculating a WACC return on deferred costs and include unamortized balances in rate base to earn a return going forward.

Q. DOES ORS AGREE WITH THE COMPANY’S JUSTIFICATION FOR INCLUSION OF A RETURN ON THE DEFERRED BALANCE?

A. No. ORS recommends the Commission apply the proper accounting treatment to the expenses contained in the deferral balances as it would absent the deferral account. This requires the deferral balances to be separated into two categories: operating-related costs and capital-related costs. The rates and revenue requirement are designed by the

Commission to provide the Company a reasonable opportunity to recover prudently incurred operations and maintenance (“O&M”) expenses, and a fair and reasonable return on its capital investments to provide customers with reliable and high-quality service.

The rebuttal testimonies of Company witnesses Smith, Wright, and Hevert failed to acknowledge the Company collected \$1.7 billion dollars in operating revenues from South Carolina customers per the Application. These revenues were paid to the Company by South Carolina customers during the 2017 test year through service rates that were designed to allow recovery of the Company’s operating costs as well as provide a reasonable return on shareholders’ capital investments.

Q. PLEASE EXPLAIN ORS’S RECOMMENDATIONS FOR COST RECOVERY TREATMENT FOR THE COMPANY’S DEFERRED BALANCES.

A. The determination of what, how and over what time period a utility receives cost recovery for accounting deferrals through service rates is ultimately within the discretion of the Commission. As I stated in my direct testimony, with the exception of the coal ash cost disallowances proposed by ORS witness Dan Wittliff, ORS recommends no additional adjustments to the actual costs incurred and deferred by the Company. ORS’s recommendation achieves an equitable sharing of deferred costs between the Company’s customers and the Company’s shareholders.

Q. WHAT REGULATORY AND/OR ACCOUNTING STANDARDS DO OTHER STATE COMMISSION’S APPLY TO THE RECOVERY OF DEFERRED BALANCES?

A. ORS’s research indicates regulatory asset recovery through service rates has been decided by state commissions largely on a case by case basis. In addition, ORS did not find

specific statutes in South Carolina that address the treatment of regulatory accounting deferrals. Historic orders issued by the Commission included various methods of deferral balance recovery. Based on ORS's research, ORS concludes, cost recovery for deferred balances is determined by state Commissions on a case by case basis.

Q. WHAT METHODS DO OTHER STATE COMMISSIONS UTILIZE TO DETERMINE COST RECOVERY TREATMENT FOR ACCOUNTING DEFERRALS?

A. The Minnesota Public Utility Commission applies a standard for the establishment of accounting deferrals and all components of the standard must be met to establish an accounting deferral. The standard is:

1. The expense must be related to utility operations for which ratepayers have incurred costs or received benefits;
2. It must be significant in amount;
3. It must be associated with unusual or extraordinary items; and
4. It is subject to review for reasonableness and prudence.

The New York Public Service Commission uses a similar, three-part test when considering approval of accounting deferrals which includes a test to determine if the extraordinary expenses are "material to earnings" (greater than 5% of income for shareholders). In Connecticut, utilities are not allowed to incur carrying costs in deferral balances until recovery begins. In New Hampshire, the decision to allow carrying costs on a deferred balance is decided case by case, but the New Hampshire Public Utilities Commission does not allow the deferral balances to be included in rate base. In Utah, much

like South Carolina, the Public Service Commission has no formal regulatory guidelines or standards and prefers to determine the treatment of deferrals on a case by case basis.

Q. COMPANY WITNESS SMITH DEFINED DEFERRED COSTS AS COSTS THE COMPANY INCURRED AND NOT CURRENTLY RECOVERED THROUGH RATES. DO YOU AGREE WITH THIS DEFINITION?

A. No. In many instances, the Company used deferral accounting treatment to preserve the Company's ability to recover expenses incurred outside of the Test Year in the next general rate proceeding. Company witness Smith overlooks some very important criteria related to accounting deferrals.

A utility should be granted accounting deferrals for costs that meet a level of "extraordinary" in terms of circumstance and magnitude.¹ Meaning, the costs should be non-recurring, unforeseen, and out of management's control, such as uninsured storm damage, losses from early retirement of major plant assets (not provided for in depreciation) or environmental and regulatory remedies imposed by local, state or federal governments. The Federal Energy Regulatory Commission ("FERC") Electric Chart of Accounts (page 286) states that in order to be considered as extraordinary, an item should be more than approximately 5% of a utility's income, computed before extraordinary items.

ORS does not believe the Company's projects for which it has deferred costs such as Customer Connect, Grid Mod, and installation of AMI meters meet any of these criteria to be considered extraordinary. ORS allowed recovery of the costs actually incurred by the

¹ Deloitte, *Regulated utilities manual A Service for regulated utilities* at 34 (Feb. 2004) <http://ipu.msu.edu/wp-content/uploads/2017/09/Deloitte-Regulated-Utilities-Manual-2012-2.pdf>

Company. However, ORS recommends the Commission not allow the Company shareholders to earn a cost of capital return on the non-extraordinary deferred operating costs.

Q. PLEASE EXPLAIN YOUR CONCERNS WITH COMPANY WITNESS SMITH'S DEFINITION OF DEFERRED COSTS.

A. Company witness Smith's definition is very broad, and if strictly applied, may allow the Company to seek more accounting deferrals for O&M costs in the future that are not classified as extraordinary. In South Carolina, a regulated utility's rates are established based on a historical test year adjusted for known and measurable changes. Since no one can predict the future, rates will often not represent all the specific operating costs that will be incurred by the Company during the time the rates are in effect. Without proper guardrails or guidelines related to accounting orders, the Commission may inadvertently allow utilities to reduce regulatory lag and shift risk to customers by establishing accounting orders for non-extraordinary expenses that occur outside of a historic test year.

The impact of this practice will be greatly inflated costs in future years which will be passed on to customers through rates. The impact will be greater if the utility is allowed to earn a cost of capital return on deferred O&M costs, during the time in which the O&M costs are deferred and while the O&M costs are amortized. This compounding of a return within the recovery of the deferred balance creates a situation where the utility earns a return on regulatory assets for the sole purpose to benefit their shareholders at the direct expense of the Company's customers.

Q. DO YOU AGREE WITH COMPANY WITNESS SMITH'S CHARACTERIZATION THAT ORS'S RECOMMENDATIONS ARE PUNITIVE?

1 **A.** No. Company's witness Smith's characterization that ORS's recommendations are
2 "punitive" is meant to convey the Company will suffer irreparable harm – which is not
3 true. ORS's recommendation to allow the Company to receive recovery of its incurred
4 expenses outside of the Test Year is fair and equitable. ORS recommends the Commission
5 limit the Company's recovery to the operating expenses because the Company provides no
6 justification for financing daily operations. The Company should not be allowed to shift
7 its risk to the customers through the allowance of a cost of capital return on O&M expenses.
8 ORS recommends the Commission approve normalized annual operating expenses for the
9 Company including approximately \$24,000,000 of amortization expense to recover
10 deferred costs which were not incurred during the Test Year. Absent specific Commission
11 guidelines or guardrails to govern deferral balance recovery, ORS recommends an
12 equitable sharing of the deferred balance of O&M between the customers and shareholders.

13 **Q. DID ORS CONSIDER OTHER ALTERNATIVES FOR TREATMENT OF COST**
14 **RECOVERY RELATED TO ACCOUNTING DEFERRALS?**

15 **A.** Yes. ORS evaluated an alternative recommendation which would limit the
16 Company's cost recovery of the deferred balances to the actual deferred costs. This
17 alternative would not allow the Company any rate base treatment of capital-related costs.
18 ORS did not advance this recommendation as it may negatively impact the Company's
19 investment in and maintenance of utility facilities to provide reliable and high-quality
20 utility services.

21 **Q. IS THE COMMISSION REQUIRED TO ACCOUNT FOR THE TIME VALUE OF**
22 **MONEY IN ITS DETERMINATION OF COST RECOVERY FOR DEFERRED**
23 **BALANCES?**

1 **A.** Company witness Wright asserts that ORS's recommendation is flawed because it
2 does not account for the fact "these dollars were not borrowed from investors for free."
3 ORS's recommended adjustments to deferred balances generously provide a return of and
4 a return on capital-related costs. However, as stated in in my surrebuttal testimony, ORS
5 does not agree that deferred O&M costs should earn a return. The Company should not be
6 allowed to shift its risk to the customers through the allowance of a cost of capital return
7 on O&M expenses.

8 **Q. DO YOU AGREE WITH COMPANY WITNESS SMITH'S SUGGESTION THAT**
9 **ORS'S RECOMMENDED TREATMENT FOR THESE ACCOUNTING**
10 **DEFERRALS SHOULD BE APPLIED TO OTHER REGULATORY ASSETS AND**
11 **LIABILITIES?**

12 **A.** No. ORS concludes cost recovery for deferred balances is determined by state
13 Commissions on a case by case basis. Company witness Smith argues that ORS's proposed
14 treatment of these six accounting deferrals, should also be applied to a regulatory liability,
15 such as accumulated deferred income tax ("ADIT"). Unlike other regulatory assets, ADIT
16 has a prescribed accounting treatment which is documented in regulatory and accounting
17 publications and guidelines. For instance, *Accounting for Public Utilities* states "[t]he
18 general view in this respect is that these liabilities represent a source of interest-free funds
19 supplied by the U.S Treasury that the utility is free to use in support of rate base investment.
20 Therefore, the rate base must be reduced by accumulated deferred income tax ("ADIT")
21 liabilities balance to avoid paying a return on funds that are cost free."² Additionally, the
22 NARUC *Rate Case and Audit Manual* states "[u]nder Statement of Financial Accounting

² Robert L. Hahne & Gregory E. Aliff, *Accounting for Public Utilities*, § 4.04[9] (2018).

Standards (SFAS) 109, Accounting for Income Taxes, companies must recognize changes in tax rates when they occur and use deferred tax accounting. The resulting comprehensive interperiod tax allocation, or income tax normalization, cause a rate base adjustment that is amortized over the tax life of the timing difference.”³ The accounting deferrals the Company is seeking to recover in this docket, do not have clearly defined procedures established to determine the regulatory accounting treatment.

Q. WILL YOU UPDATE YOUR SURREBUTTAL TESTIMONY BASED ON INFORMATION THAT BECOMES AVAILABLE?

A. Yes. ORS fully reserves the right to revise its recommendations via supplemental testimony should new information become available not previously provided by the Company.

Q. DOES THIS CONCLUDE YOUR SURREBUTTAL TESTIMONY?

A. Yes, it does.

³ NARUC Staff Subcommittee on Accounting and Finance, *Rate Case and Audit Manual*, pg. 24 (2003)